Outlook 2010
Hope of recovery
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A pale winter sun. This is the image that best typifies the economic recovery that we can look forward to in 2010. Pale, because we are far from spring. A thriving economy, such as we experienced in the years 2004-2007, is currently well beyond our reach. Officially, the recession is over, but the recovery is slow and uncertain. For the year ahead, our economists predict a meagre GDP growth of 1%.

Here you have Rabobank’s Outlook 2010. An analysis of economic developments that may be described as lying between hope and fear. It appears that the crisis, that has afflicted the real economy of this country since the second half of 2008, has severely undermined the growth potential. It will take years before we have made up the loss of output incurred through the economic and financial crisis. On the bright side, however, even after 4% of economic contraction, the Netherlands is still a prosperous country. Our average income is still at the level of 2006, and we were then richer than ever before. Yet this is cold comfort to the many citizens who have lost their job or will lose their job during the year ahead. After all, our economists expect that unemployment will rise to 7¼% next year.

Does this mean we should be fearful of an employment scenario like that in the eighties? In a special chapter in this issue of Outlook, our economists answer this question with a definite ‘No’. There will be comparatively fewer people available for work in the years ahead, and the labour market has become much more flexible. While the severity of the recession will indeed cause unemployment to rise next year, a shortage of labour may recur within a few years, chiefly due to population ageing.

Grounds for hope for our open economy are found in the signs of recovery in world trade. Yet in this respect too, it is wise to be prudent. As yet, the world lacks a sustainable growth engine. The financial sector is in the process of rebalancing. In the US, consumers are encumbered by high debts and a rapidly deteriorating labour market. European consumers are plagued with fears about the future. Most people understand all too well that the various economic support measures will ultimately have to be paid back in the form of higher taxes. Perhaps the Asian consumer can boost the recovery in world trade. However consumers in emerging Asian economies often prioritize saving over spending, because of the absence of a social security net and poorly developed financial markets.
While confidence among Dutch producers and consumers is expected to improve in 2010, it is currently still negative on balance. Again we are faced with a contraction of investment and consumption. On a more positive note, the housing market is expected to enter calmer waters.

The situation regarding government finances looks far from promising. While the 2008 budget still showed a (too) small surplus, we are now looking into a deep hole. And this hole will get bigger next year before it gets smaller. This is partly due to the crisis, but also partly because the government failed to build up a sound budgetary surplus during the boom years. In the years ahead, the political debate will be dominated by arguments about ways to address this deficit.

We know that the emerging recovery will not send us rushing back to the boom years of 2004-2007. The changes to the economy are too drastic for that to be possible. The upswing during that period was based on an unstable foundation of easy credit, ever lower risk premiums, and liberal lending. Quite rightly, these doors have now been closed, and the recovery will be a sober one. For the time being, we have only a pale winter sun to warm ourselves. But despite this less than festive message, I hope you enjoy reading our Outlook 2010. And I wish you and yours health, happiness and success in the year ahead.

**Piet Moerland**
Chairman of the Executive Board
Rabobank Nederland
For the financial markets, the past year can be compared to a roller-coaster ride. First headfirst downwards with several terrifying swerves, especially after the collapse of US investment bank Lehman Brothers; then the adrenaline-charged anticipation of the upward climb. Policymakers had to resort to a wide range of monetary and fiscal stimulus measures to come to grips with the crisis. A painful recession proved inevitable, but a depression was averted. Worldwide, there is economic recovery to be seen, and this will continue into 2010. The main factors driving the recovery are the drastic budgetary and monetary stimulus measures and the necessary rebuilding of inventories. The global pickup of producer confidence stands out in this respect. The restored confidence since the second quarter of 2009 is a good example of Keynes’ notorious ‘animal spirits’, although this has yet to be reflected in a real upswing in corporate investment.

In absolute terms, what we are really seeing is a meagre recovery. As yet, it is a recovery that does not have a sustainable growth engine. The financial sector is in the process of restructuring. The US consumer is crippled by high debts and a rapidly deteriorating labour market, while the European consumer is highly anxious about the future. Many consumers are all too well aware that the various stimulus measures will ultimately have to be paid for via higher taxes, increased inflation, or a combination of both. The Asian consumer may afford some relief, but not much.

A joyless recovery:
no reason to party
Box 1: Economic alphabet soup

There is often heated discussion on the issue of the shape that economic recovery will take. The letters of the alphabet are bandied around to illustrate the various perspectives: the V-shaped recovery versus the W-shape of the double dip are the most frequently cited; however, the letters U and L are also part of the economic lexicon.

Currently, there are clear signs of recovery in the OECD. The first phase is strong. A wide range of monetary and fiscal stimulus measures have brought about a positive turnaround in confidence and in the dynamic of inventory re-building. Unfortunately, these are just temporary factors, while in the long term, there is an absence of a clear growth engine. It will take time to reduce the global imbalances that have been building up and find the path to sustainable recovery.

In our view, the shape that economic recovery will take looks more like a mathematical symbol: the square root, albeit with a certain artistic licence. The first part of this symbol resembles a V, reflecting plummeting economic activity followed initially by a strong recovery. However, the initial pickup fails to restore production volume to pre-crisis levels, which means the recovery will tail off.

The most important realisation is that recovery will not mean a return to the economic boom time of 2002-2006. The economic reality has changed drastically since then. The boom of that period was based on what now transpires to be an unstable structure of easy credit, ever lower risk premiums and liberal lending. On the face of it, government finances appeared strong thanks to the economic upswing, but fundamentally, there were significant weaknesses. Accordingly, the starting point was less favourable than was previously assumed, and governments and central banks have subsequently had to pull out all the stops, in the face of the crisis and the prospect of a deep depression. In doing so, they have borrowed well into the future. We expect to see a gradual correction of the global imbalances. But the price of this is a joyless recovery. It will take years for the loss of wealth to be restored. And the lost growth may never be fully recovered.

more. Consumers in Asia tend to save a lot, on account of the deficient social security net and poorly developed financial markets. Consequently, economic growth in many countries will be well below the level we might normally expect when emerging from a recession. Yes, a depression has been averted, and a modest recovery is underway, but there will be no party.
Asia: the first to recover

Searching for an economic turn for the better and ultimately for economic recovery, we simply cannot pass by the Asian economy. Looking at regional trends in Asia over the past year or so, a sharp fall in economic momentum can be seen in many countries that continued into the first quarter of 2009. Almost as quickly as growth momentum around the region waned, trends reversed in the second quarter and the outlook became much less bleak (Figure 3). Several economies in the region recorded positive growth in the second quarter and those that didn’t, saw a sharp reduction in the rate of contraction. This improvement is noteworthy because, by and large, it preceded the return to growth recorded in the US in the third quarter of 3.5%, which is the region’s main economic partner.

The strongest shoulders bore the largest weights
The countries that experienced the sharpest downturns were the richer economies in Asia. The less developed economies generally experienced much shallower downturns with some e.g., Indonesia, avoiding a contraction altogether. The important difference between the two groups is the significance of the financial sector (ground zero in the recent global downturn) to each economy and the exposure to global demand for higher value manufactured and electronics products. The richer economies in Asia have more developed financial systems that are more intertwined with global financial trends, and are generally more dependent on OECD demand for their manufactured and electronic exports.

There was an additional factor that compounded the above fundamental negatives over the past year or so. As global weakness spread to Asia, some producers, with the memory of financial stress resulting from the Asian financial crisis of the late 1990s and the Dot-com bust of early this decade, acted quickly to reduce costs. Inventories were cut dramatically. Singapore’s economy, for example, contracted -9.5% year-on-year in the first quarter of 2009. But private consumption only fell -4.2% in the same period. In Taiwan, GDP contracted -10.1% year-on-year in the first quarter whilst private consumption fell only -1.6%. Consumption is the largest sector of most economies yet these data show that relative stability in consumption in some countries couldn’t offset other negatives. We emphasise the role of inventory run-down in under-cutting regional growth. Many producers effectively switched off their machines and supplied customers from inventories. Inventories are a small part of most economies but can be highly cyclical and have far ranging impacts. Output declined precipitously around the region through late 2008 into early 2009.

No more Games
Besides the downturn in the global financial sector and the weakness of global demand transmitted to the region through export channels, there was one other factor that undercut regional growth momentum and this one was home-grown. The Beijing Olympics were preceded by massive renewal and upgrading of infrastructure and also by large scale commercial and residential developments in Beijing and in many of the large north eastern cities. The scale of such activity
dwarfed the construction of Olympic-specific facilities such as the Birds Nest stadium, etc. For example, whereas Sydney extended a train line by a few hundred metres in preparation for the 2000 Olympics, Beijing expanded its subway system by a factor of three. When the medal tally was in and the glow of China’s success had faded, there was significantly less employment opportunity in many cities and this reinforced the weakness coming from export markets. The economy ground to a stand-still in the fourth quarter of 2008 and the first quarter of 2009.

**Orchestrated recovery**
In response to weaker domestic growth, China’s government has loosened policy considerably and this has had a rapid impact on China’s growth momentum over recent quarters. Whereas in July 2008, on the eve of the Olympics, the central government had a cumulative 12 month budget surplus of CNY480.5 bn, the latest budget numbers show an annual deficit of CNY736.5 bn through the year to September 2009, a sharp deterioration. Government policy has also boosted the economy in other ways through moral suasion on the banking sector. Bank lending increased by an average of CNY307.6 bn in each month from Aug 2007 to July 2008. Then, as the slowing in the economy became apparent, lending accelerated and increased by CNY1.54T (yes, trillion) in each month of the first quarter of 2009. This stimulus is flowing through the economy and contributes to current growth momentum. *Figure 4* shows recent trends in these two indicators.

**Growth potential remains intact**
Looking ahead, the profile we expect for China is for growth to accelerate further in the fourth quarter of 2009 and the first quarter of 2010 from 3 quarters of robust 8.9% year-on-year rate, but to slow thereafter. This slowing is driven by a reduction in fiscal and bank-driven stimulus. Confidence among policymakers has already increased and concern over potential bad loans down the track has risen. By late 2009, the budget deficit has already shown early signs of improvement. This is also true of growth in bank lending; it too slowed into late 2009. Couple these factors with a modest outlook for demand conditions in China’s export markets and we see economic growth losing steam into the middle of 2010 and settling at about an 8% rate.
Our point in discussing the variety of negative factors that derailed regional growth momentum through the past year or so is to highlight the transitory nature of several of the elements. The cyclical swing resulting from the Olympics is passing and China’s underlying structural positives are re-asserting themselves. The underlying momentum of modernization and urbanization for millions of China’s population is captured in Figure 5. Of China’s population, 43% had incomes above the national average of $3,300 (in 2008) whilst 57% have incomes below. This largely reflects the divide between coastal and inland regions and this chart highlights the scale. There are about 740 million people still to play catch up with their 560 million richer countrymen. We expect the national average income to continue rising over time and we also highlight the scope for development to broaden. Many of the 740m people are still looking forward to the fruits of development spreading from the congested coastal areas to inland provinces. If we think of these people as a stand-alone country of 740m people, it would constitute the third most populous country in the world.

**Low-hanging fruit**

Most economic indicators in Asia’s other heavy-weight, Japan, show an economy growing at a robust rate. Whether it be retail spending or industrial production, recent updates show an economy on trend improvement. Alongside the improving domestic economy, the trade sector is participating in normalizing global demand. But the dominant issue overhanging these signs of an improving economy is the depth of the recent recession. The economy contracted 8.4% year-on-year in the first quarter of 2009 and even after returning to quarterly growth in the second quarter of 2009, the economy was 7.2% smaller than the same quarter of the prior year. This was a brutal recession and we characterise the current improving trend as ‘the low hanging fruit of recovery’. Japan is merely regaining lost output rather than pushing its own production frontier to new levels. We doubt policymakers at the Bank of Japan (BoJ) will be altering policy for many months as they view recovery through the prism of the recent sharp downturn. On this issue, it is significant that the BoJ only reduced interest rates from 0.5% on the eve of the financial crisis to the current 0.1%. We doubt the men and women on the streets of Japan even noticed.

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**Figure 5: Chinese population by income**

- Population, above the average income
- Population, below the average income

**Figure 6: Does anybody in Japan notice the stimulus?**

3-month interbank rates, %

Source: Rabobank

Source: Reuters EcoWin
the difference. As such, Japan is in a different position from other major economies that were able to reduce interest rates by significant margins to combat their respective recessions, see figure 6. As Japan’s output nears its pre-global-recession level, probably not until 2011, we anticipate a return to a lacklustre growth rate. The BoJ is expected to increase rates very tentatively when they do start.

**Not decoupled**

Accordingly, economic recovery has announced its presence first and most strongly on the Asian continent. But if the rest of the world does not catch up quickly, it looks as though it will miss a lot of the momentum, and Asia is not sufficiently advanced in its development to pull the rest of the world along in its slipstream.
United States: the consumer between a rock and a hard place

In contrast to Asia, the US economy does have the potential to pull the rest of the world along in its wake. And the US economy has found the path upwards, albeit one pitted with bumps and potholes. A difficult path to travel for the economy’s main engine, the US consumer, which is still undergoing repairs. After years of extravagant consumption, using borrowed money, the US consumer has run up a hefty debt. This was temporarily offset by a strong rise in the value of homes and share portfolios. Unfortunately, house prices fell by a total of 33% between July 2006 and April 2009, and shares plummeted by as much as 57% between October 2007 and March 2009 (figure 7). Since then, both house and share prices have started to rise again, but for house prices particularly, a rapid return to pre-crisis levels is unlikely. For home-owners this means that a sizeable share of the wealth loss is permanent. And that is not the only problem for the household budget. The fallout from the recession has affected job security (figure 8). This recession has already seen the loss of over seven million jobs, compared to the two previous recessions when job losses remained limited to 1.3 million (1990-1991) and 1.6 million (2001). The effect on business has been a sharply reduced cost base, which has contributed to economic recovery; but the pain for households remains undiminished (figure 9). Loss of both wealth and job security along with an ongoing high debt burden has forced consumers to save more. The result is a lower contribution by consumer spending to economic growth. Consequently, we expect 2010 to see a modest growth percentage by American standards of 2.3%. However, more restrained consumption is not the only problem facing the US. The extraordinary policy measures taken to combat the recession will continue to impact on the economy for a number of years to come.
Mortgaging the future
The US government has opted to combat the crisis and the recession with an ambitious financial stability plan of $700 bn and a massive stimulus package of $787 bn. There are even calls for an additional economic stimulus package to prevent a drop in the growth rate from 2010 to 2011. However, in our view this is unlikely. If the US government wants to hold onto its AAA status and hence its access to relatively cheap financing on the capital markets, it will soon have to address the severe imbalance in government finances (figure 10). It will take years of cutbacks and tax hikes, at the expense of economic growth, to reduce the sky-high budgetary deficit (11.2% of GDP in 2009). In the coming years, America will have to pay the price of its budget policy during the recession and the credit crisis in the form of lower economic growth.

The time bomb under the budget
A complicating factor is that the US budget is not only battling with the costs of the recession, but also with the rising costs of the welfare state. Population ageing and the rising costs of health care are driving up the costs of programmes such as Social Security (pensions and disability insurance) and Medicare (health care for elderly and disabled) more rapidly than the pace of the payroll tax revenues. Consequently, according to projections from the Congressional Budget Office, by 2043 it will no longer be possible to pay Social Security out of income tax revenues. Funding of Medicare is even more precarious, because of the continuing rising costs of health care. Accordingly, Medicare is predicted to become unaffordable by 2017. Reform can certainly make a contribution to affordability, but the leeway for cost savings in social programmes is very limited. Tax increases would therefore seem inevitable in the long term, but this will have a slowing effect on economic growth.
Inflation tax and new bubbles
The monetary policy experiment of the US central bank will also leave its mark on the economy for the coming years. The Fed has effectively pumped an enormous amount of money into the financial system (figure 11). This was done to prop up the banks, keep mortgage rates low and maintain a credit flow for businesses and consumers. Thus the economy was prevented from sinking into a downward spiral. However, the problem remains of pumping the excess liquidity out of the system on time. Although Fed President Bernanke has broadly outlined his exit strategy, a number of important details have yet to be defined. In the meantime, the enormous pool of liquidity in the financial system constitutes a potential inflation threat. Although under normal circumstances there is only a weak association between money growth and inflation, this correlation becomes more marked where there is extremely high money growth. So far, the explosion of the reserves held by the banks with the Fed has not yet resulted in a sharp rise in money creation. However, as the recovery in the financial system advances, money creation will increase.

In order to restrict monetary growth, the Fed will want to mop up the excess liquidity during the coming years. This will be accompanied by a rise in the policy rate, which we expect to reach 1.75% by late 2010, followed by a further rapid increase. However, if the implementation of the exit strategy runs into problems, this could lead to increased money growth and hence additional inflation risks. In that case, the extremely expansive monetary policy pursued, that kept the credit channels open during the recession, could result in an inflation tax for consumers during the recovery. Furthermore, excessive liquidity can also result in new bubbles which could jeopardize financial stability once more during the coming years. As long as the US dollar is used as a ‘funding currency’ throughout the world for investments in high yielding currencies and emerging markets, these bubbles could be blown around the globe.
**Faulty ignition switch**

The longest US recession since the Great Depression is over. But it has left a sting in its tail which will be felt for many years. In the America that is now in recovery, both consumers and government are in the process of trying to balance their books. This process will be accompanied by a lower rate of economic growth than we are accustomed to from the US. In the past, US economic growth tended to be financed by considerable debt accumulation. However, a repeat of that pattern would now be unwise and is unlikely. The growth path now being taken lacks some of the usual momentum, and will therefore be less capable of towing the rest of the world along. In Europe, this time we will therefore have to rely more on our own strength to achieve economic growth.

**Table 1: United States key figures**

Year-on-year volume changes (%) unless otherwise indicated

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<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
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<tr>
<td>Gross Domestic Product</td>
<td>0.4</td>
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<td>Household Consumption</td>
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<td>Inventories (contribution to growth)</td>
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<td>0.8</td>
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<tr>
<td>Inflation (%)</td>
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<td>Unemployment (%)</td>
<td>5.9</td>
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United Kingdom: a recovery that doesn’t feel like one

The near 6% contraction of the UK economy in the six quarters to Q309 should be seen in the light of the unprecedented period of 63 quarters of positive growth that preceded it. Nevertheless it marks the longest period of a shrinking economy since comparative records began, underlining the scale of the downturn (figure 12).

Brittain as Little US?
Rising consumer spending was key to the previous record breaking advance in the economy, largely predicated upon mounting property prices and increased leverage generated by cheap and readily available credit. Of course the advent of the credit/banking crisis has seen an end to easy credit and consumers are being forced to deleverage. While it would appear that the residential property markets are rebounding when looking at recent monthly data, the sector remains acutely vulnerable to the spectre of rising unemployment, an eventual turn in the rate cycle and ongoing credit restrictions.

Voting for recovery
Additionally when looking forward to the upcoming year there are a number of recovery hurdles to overcome, including fiscal tightening as the authorities attempt to rein in a burgeoning fiscal deficit. Moreover there are political issues to incorporate ahead of the forthcoming election, to be held by June 2010. The prospects of a change in government remain high, but there are some residual risks of a ‘hung’ Parliament with no single party in control. That could prove a hugely damaging state of affairs not seen since the early 1970’s. Despite these concerns, we have cautious expectations of a modest recovery ahead. The combination of aggressive monetary easing (figure 13), allied to a modest fiscal loosening and a substantial weakening in the trade weighted value of Sterling should help provide the foundations for a modest rebound in activity in the coming months.

Figure 12: Contributions to real GDP growth

Source: Reuters EcoWin
Even as we expect a return to growth in 2010, growth at 1.3% will remain significantly below the 2¼-2½% trend rate, because a deleveraging consumer is both unwilling and unable to return to the prior pace of consumption growth. Naturally such a return and corresponding asset price bubbles aren’t optimal in any case. One bright light is the relative flexibility of the UK labour market. During the period of recent economic weakness we have seen a substantial increase in unemployment (figure 14), but at least for the period ahead it looks to us that the gloomiest scenarios are overdone, although against our relatively lacklustre growth forecasts the labour market won’t truly recover until 2011 at the earliest. The prospect of cautious gains in private spending combined with a small positive net trade contribution leaves moderate grounds for optimism with regard to the overall UK outlook.

**Weak sterling may push rate hikes forward**

We see a risk of imported inflationary pressure being the flipside of a competitive Sterling which risks a hike coming prior to the end of the first half of the year, while we anticipate rates heading back towards 2% by year end, reinforcing the risks of only a modest recovery.
Eurozone: out of recession but minus the sparkle

The eurozone economy has also gone through a deep recession. In the fourth quarter of 2008, the economy contracted in real terms by 1.8% quarter-on-quarter and in the first quarter of 2009 the decline was a much as 2.5%. Confidence among producers and consumers plummeted to record lows in early 2009. Investment retracted sharply and European consumers kept their purses closed. In a remarkable development, even external trade contributed negatively to growth. In previous recessions the contribution of net exports was generally positive for GDP growth, because imports contracted faster than exports. This time round, however, exports were dealt a particularly severe blow by the depth of the recession in world trade.

Pain unequally distributed
Throughout Europe, the recession was not equally severe everywhere (figure 15). Large differences are visible in the eurozone, with Slovenia, Finland and especially Ireland hard hit by a sharp correction in the housing market. In Spain, the GDP drop in 2009 appears mild compared to other eurozone countries, but this is deceptive. In recent years, Spain had got used to high economic growth, but growth is currently being strangled by a sharp downturn in house prices. Countries that have failed to address fundamental imbalances (including excessive wage growth) are being hardest hit. Italy is a good example in this respect. But even a relatively healthy economic structure is no guarantee of immunity: Germany, still the so-called ‘world champion of exports’, has seen a sharp drop in GDP in 2009. This is partly due to external factors, such as the steep decline in demand for capital and durable consumer goods, as well as the country’s large-scale interests in Central and Eastern Europe. France, on the other hand, stands out in a positive sense, although it too has been unable to escape a recession. The French economy benefited from substantial state assistance, and from being less dependent on (external) demand for capital goods. In true Gallic style, President Sarkozy intervened with a firm hand in both the financial sector and, importantly for France, in the automobile sector.

Recovery dawns …
At last, the economic contraction in the eurozone has come to an end. The blow was enormous, but the speed of the recent recovery is also remarkable, and can largely be attributed to the heavy-handed intervention of central banks and governments. Since the first quarter of 2009 we have seen a strong improvement in sentiment on the financial markets, and this has had a positive impact on the economy. The excessive pessimism that prevailed at the end of last year and early this year has turned in a more positive direction, which in itself can be seen as a precursor of economic momentum (figure 16): the so-called ‘animal spirits’ of Keynes. Share prices, which have risen on balance since March 2009, are now contributing to an improvement in consumer confidence.
... but a robust recovery cannot be taken for granted

On the whole, the above-cited factors are contributing to a further recovery of growth in the eurozone. There is considerable evidence that 2009 will end with positive economic growth. Indeed, at 0.4% quarter-on-quarter, growth has decidedly turned positive again in the third quarter. Thus, we are leaving the recession behind, but we cannot assume that there will be a continued robust recovery in 2010. In fact, a growth rate of well below the recovery periods of the past is likely. We expect the initial growth momentum to rapidly deflate during 2010. In an extension of our above analysis of Asia and the US, we expect that world trade growth will not make up the deficit accumulated in early 2009 any time soon. Furthermore, the potential for European exporters to benefit from world trade recovery is hampered by the sharp rise in the trade-weighted euro exchange rate. Accordingly, a classical, export-driven recovery may seem rather unlikely. Furthermore, the underlying problems in the financial sector have not yet been fully resolved – a danger which the IMF recently again pointed out. The European banking system still faces the prospect of substantial credit losses. The worst of the mess regarding the US ‘junk mortgages’ may indeed be behind us, but traditional forms of credit are now under pressure as a result of the recession. The IMF singles out medium-sized and small businesses, which account for the bulk of corporate loans in the European banking systems, and where the recession has further increased the threat of credit losses. Furthermore, funding costs for banks have risen, despite the expansive liquidity policy of the central bank, while the potential profit growth of banks is under pressure. The necessity of restoring order to the balance sheets continues to overshadow the sector, which certainly means that any growth momentum for the economy cannot be expected from this quarter.

Limited scope for policymakers

The success of the policy interventions is not without substantial economic risks for the future. After all, central banks cannot keep the liquidity tap open indefinitely. In early November, the ECB intimated its intention to gradually tighten the credit flow. Government finances also need to be tackled in many countries. In general,
governments have not had too many options, and rightly have reacted to the global drop in demand by cutting taxes, speeding up investment in infrastructure and implementing programmes to support the labour market. Specific programmes, such as car scrappage schemes have been effective. Car sales in the eurozone (measured in thousands of cars sold) were over 15% higher in October than a year earlier. Yet, all these stimulus measures incur a substantial debt for the future (figure 17). So the challenge lies in gradually exiting the stimulus programmes on time. Gradually, to prevent the economy from slumping back and on time to prevent the poor state of government finances from becoming entrenched. European policymakers do not yet appear to be fully aware of this challenge. Portuguese Prime Minister, Socrates, recently unfolded ambitious plans for large-scale infrastructural investment in his country (€60 bn for the next ten years). In Germany, the new coalition has agreed a hefty tax reduction of €24 bn, without any sign of there being a corresponding spending cut to compensate. And the French government has announced its intention to extend the crisis measures until 2010, in combination with new tax cuts. The picture is clear: although 2010 will show a cyclical recovery, governments are not yet willing to risk loss of momentum in the private sector. Consequently, budget deficits will rise further in 2010, with less room left for manoeuvre.

No traditional upswing in investment
Taking a closer look at our estimates for the eurozone, we see a lag in investment activity. Although the level of investment will rise somewhat during 2010, base effects will ensure that average growth for the year as a whole will remain slightly negative. This is much lower than usual after a recession. Furthermore, part of this growth will still be fuelled by government infrastructural programmes announced in late 2008 and early 2009. In a number of countries the effects of the weak housing market have not yet run their course. Although confidence among European entrepreneurs has improved considerably in recent months, we see this as a relative improvement. Indicators of capacity utilization still show record lows, and although risk premiums in the financial markets have plummeted in recent months, financing conditions for banks and companies remain considerably less favourable than before the crisis. Profit growth for businesses may improve

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<td>Inflation (%)</td>
<td>3.3</td>
<td>0.3</td>
<td>1.0</td>
</tr>
<tr>
<td>Unemployment (%)</td>
<td>7.6</td>
<td>9.4</td>
<td>10.6</td>
</tr>
</tbody>
</table>
somewhat, now that wage growth in many countries is clearly abating, but profit levels have dropped to a low ebb. Besides greatly increased wage costs, now higher raw materials prices are adding to the downward pressure on profits (Figure 18). On the whole, the financial scope as well as the necessity for investment will probably be limited in 2010. Not until 2011 will we be likely to see investment growth return to a ‘normal’ pattern.

Glimmer of hope for consumers

It will be slim pickings for most European households in 2010, with perhaps the occasional sweetener. The main consolation is that inflation has come down considerably in 2009 and is likely to remain subdued in 2010. This will benefit households’ real purchasing power. Furthermore, the recovery in the financial markets has led to an improvement in the net financial position of households in recent quarters. This leaves room for a limited drop in the savings rate, which from an international perspective is on the high side (Figure 19). The drop in the savings rate might have been steeper, but for the further rise in unemployment, which will be particularly marked in the first half of 2010. Wage development is a different story. Until recently, wage growth was relatively strong in many eurozone countries, as a result of long-term wage agreements that dated back to before the recession. Furthermore, the slide in production was so rapid and sudden that it was impossible for wages to adjust at once. Since then, the situation has changed and we see wage growth dropping substantially in many countries with the pressure of rising unemployment. We expect this pattern to continue through 2010. Accordingly, the prospects for disposable income are relatively dim: both for employment and wage growth, there is little in the way of a silver lining. Tax cuts in some countries may offer some relief, but on the whole we expect no more than a minimal rise in consumption of about 1% in 2010.

New challenges for the ECB in 2010

A major dilemma for monetary policymakers is that the medicine used to combat the crisis (cheap credit) is at the same time one of the catalysts blamed for the development of bubbles in the credit markets, indirectly leading to the crisis. We are not pointing the finger primarily at the ECB in this respect. Monetary expansion in
the eurozone has - besides the limited covered bonds initiative - mainly consisted in creating liquidity, and provided this is extracted from the system on time, it should have no effects on eventual monetary growth, inflation or the development of new bubbles. However, we do expect that in a calmer economic climate, the ECB will turn its attention to the possible side-effects of the medicine it has dispensed.

**No conventional reasons to hurry…**

Since October 2008 the ECB sharply reduced its policy rate, culminating in a record low of 1% in May 2009. At the same time, it pursued a policy of monetary expansion, which pushed money market interest rates even lower than the official policy rate (figure 20). In fact, the 3-month Euribor rate fell to below 0.72% in early November. While the economy has clearly found the path to recovery, recent assertions by policymakers, including ECB president Jean-Claude Trichet, give the impression that the ECB is not in any hurry to change its policy any time soon. Economic recovery is still too fragile and the risk of inflation is limited. On the whole we share this view. However, we do envisage some rise in inflation in the coming months, largely on the back of higher oil prices. We expect inflation to average around 1% for 2010. In view of our modest growth projections for the eurozone, the inflation risk for 2010 would appear to tip towards the downward side rather than the other way around.

**…but an end to unconventionally low interest rates**

That the ECB should nevertheless raise its policy rate in the second half of 2010 is based on the assumption that it regards the current low interest rate as an exceptional measure. We think many ECB council members must be feeling increasingly uncomfortable with an interest rate level of 1% in a recovering economic climate. In fact some of them didn’t want to let interest rates fall below 2% in the first place. Furthermore, central banks run the risk of creating new bubbles in the financial markets with their expansive monetary policy (figure 21). Policymakers increasingly seem to realise that it is better for a central bank to be ahead of events than only to step in once the bubble has burst. This is why we expect the ECB to raise its most important rate (the refi rate) by 100 basispoints in the second half of 2010, which will by no means be restrictive.

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**Figure 19: Stock market rally can lower households savings**

Index (l-axis), % of disposable income (r-axis)

Source: Reuters EcoWin, Rabobank

**Figure 20: Money market interest rates drop below the policy rate**

%  

Source: Reuters EcoWin
**A change to the provision of liquidity?**

However, before it can take this step, the ECB will probably first tackle the excess liquidity in the money market. We expect the spearheads of policy to be aimed in that direction in the first half of 2010. Although an exact plan of action is not known, it would appear inevitable that the ECB must discontinue a number of measures, or else tighten lending conditions. Recent statements by Bundesbank-president Axel Weber point in this direction. Expansive liquidity policy is really based on three pillars: acceptance of a wide range of collateral, a maximum maturity of 12 months for credit extended to banks (formerly three months), and a policy of full allotment of bank’s liquidity requests. Because the average credit maturity has shifted markedly towards maximum maturity, there is a danger of new problems in the future (figure 22). In particular, the highly successful liquidity injection of June 2009 (€442 bn), incurs a certain ‘roll-over’ risk. Moreover, it is difficult to create unlimited 12-month liquidity in an environment where the markets are anticipating a (strong) rise in the refi rate during that term. One possible solution would be to impose a maturity premium on the standard fixed rate. The market will then naturally incline towards the shorter end of the money market curve, particularly if the said premium also gives an indication of the pace of interest rate growth. In any case, we expect liquidity in the money market to decline during the course of 2010, whether by natural means or contrived. This will allow money market rates to rise somewhat in the first half of the year. Market anticipation of policy rate increases may well intensify the upward trend. By the end of 2010 we expect to see a 3-month Euribor rate of about 2.25%.

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**Figure 21: Growth of broad money (M3) in the eurozone has picked up pace since 2001**

Ratio of broad money and eurozone GDP (index, 1999 = 100)

Source: Reuters EcoWin, Rabobank

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**Figure 22: ECB loans to the banking sector**

% bn

Source: Reuters EcoWin
**Capital markets:**
investors venturing out from safe havens

Although 2009 can be regarded as another turbulent year for fixed-income markets, volatility is a relative concept: compared to the previous year, 2009 was an oasis of peace. At the same time, regional divergence needs to be highlighted. In the US on the one hand, we saw strong fluctuations in the yield on 10 year government bonds, from a record low in early 2009 to 4% halfway through the year. In Germany, on the other hand, the 10 year yield kept within a relatively narrow range of between 3.1 and 3.7%. The spreads between various eurozone countries and benchmark country Germany, which in late 2008 were still very wide, narrowed noticeably from the first quarter of 2009 (figure 23).

To a considerable extent the correction on the US bond market, and the bond market in general, can be seen as an improvement to the liquidity in the markets and a return to normal prices. In late 2008 and early 2009 the government bond market was overvalued because US Treasury paper (and to a lesser extent German government paper) was functioning as a safe haven for investors. Furthermore, in many countries inflation had slowed considerably as a result of exceptionally large price drops on the commodity markets. Add to this the fear of a global depression, and the historic low levels are somewhat understandable. Yet this analysis does not fully explain why interest rates subsequently rose so rapidly. Raw materials prices recovered in early 2009, and the economic turnaround focussed people’s attention on the significant (inflationary) risks attached to America’s aggressive monetary and budgetary policy, for which a price must ultimately be paid. However, it is the return of appetite for risk among investors since the first quarter that dominates the picture. Investors were once again prepared to take the plunge, and began to exchange their safe Treasuries and Bunds for higher risk paper, such as shares and corporate bonds. The result was a sharp climb in capital market interest rates until early June.
Mixed feelings
In the light of world economic recovery, increased inflation expectations in the market and growing appetite for risk among investors, it is surprising that capital market interest rates have declined since the summer (figure 24). Between early June and the beginning of November, the 10-year swap rate in the eurozone has dropped by 30 bps and by as much as almost 60 bps in the US. Uncertainty about the sustainability of the recovery has not fully evaporated from the markets, and the main central banks recently indicated their unwillingness to invoke their exit strategies any time soon. This has kept a lid on shorter term capital market rates. Furthermore, many investors will have “put their money to work” across a broad range of financial securities. And this may explain why the prices of many different investment instruments rose simultaneously. All good for market sentiment, but also worrying, in view of the risks for the medium term and the said reluctance of central banks to restrict monetary policy. The danger is that current low interest rates may spark a tendency towards greater risk-taking.

Box 2: Support measures for the main course, inflation for dessert?

Will the vast array of measures adopted by central banks and governments ultimately lead to an uncontrollable surge in inflation? It may appear strange to discuss uncontrollable inflation at a time when many countries are experiencing almost zero or even negative inflation. But let us weigh up the arguments for and against.

Those in the deflation camp reason that the enormous capacity surplus caused by the crisis in the western economies will continue to exert downward pressure on prices. Furthermore, workers have lost negotiating power due to higher unemployment, and companies’ profit margins have been eroded. Weak economic recovery combined with a fundamental rebalancing of the financial sector as well as increased tendency of households to save instead of spend will ensure that the excess capacity will remain in place for a relatively long time. This therefore, it is argued, will contribute further to deflation.

Exponents of the inflation argument envisage large risks in the medium term. The large-scale interventions and liquidity injections from central banks and the enormous governmental stimulus packages to avert a depression have a downside (figure 25). These measures increase the risk that once the economy makes a clear turnaround, an uncontrollable surge in inflation could be the result. The theory is that governments and central banks will be too late with their exit strategy. Central banks will remain focussed on supporting the financial sector, as long as the process of debt reduction is underway. And governments - even if only for political reasons - will be just as reluctant to withdraw their stimulus packages.

Both arguments emphasize extreme scenarios. The deflationists base their arguments entirely on the relationship between excess capacity and inflation (figure 26). Analyses do indeed bear out this relationship but the strength of the correlation is heavily influenced by inflation expectations and the underlying confidence that economic actors have in central bank policy. Well-anchored inflation expectations ensure that actual inflation is much closer to the central bank’s aims than might be presumed on the basis of capacity utilization. There is another more technical problem: the production potential of an economy is difficult to measure. It is entirely possible that the production (growth) capacity of the economy has declined as a result of the recent crisis, which means that the capacity surplus is smaller than we think. Based on these considerations and on our growth scenario for the global economy, we estimate the risk of deflation in western economies to be still relatively low.

The assumptions of those in the inflation camp are largely based on the highly inflationary effects of the extremely loose monetary policy. The major central banks try to debunk this fear by pointing out that many of their liquidity generating measures will automatically expire once there is no longer any need for them. This assertion also needs to be qualified. To simply discontinue liquidity
Outlook: eventually higher

Although inflation is currently at a low ebb in the western economies, and the risk of downward pressure remains, the business cycle gives rise to expectations of a clear rise in capital market rates, particularly within a six to twelve month period. The global economic recovery certainly underpins this view, although it is as yet far from prodigious. As such, it gives the central banks sufficient basis for discontinuing the extraordinary measures. This will be accompanied by a rise in money market rates which will also push bond yields upwards. In this context we should mention the ending of the Fed’s Treasury paper purchasing programme in the US, which should no longer have a downward impact on bond yields. Furthermore, in 2011 the Fed may well have to step harder on the brakes than is now factored in by the markets, which is another reason why we may see bond yields rise more sharply in the US in 2010 than in the eurozone. In addition, from a long-term ‘fair value’ point of view, we see that bond yields in the western world are currently relatively low, and are an insufficient reflection of the risks attached to greatly increased budgetary deficits, particularly the cyclically-adjusted component.

Programmes could lead to problems, for instance because it will reveal banks’ counterparty risks, which could give rise to renewed deterioration in market circumstances. Furthermore, if the Fed or the Bank of England were to withdraw their unconventional measures, for example by re-selling some of the previously purchased long-term securities, this could result in a significant rise in yields. This prospect alone could induce central banks to postpone the withdrawal of measures. Clearly, therefore, central banks will have to proceed with the utmost caution and will leave measures in place for longer than strictly needed on an economic basis. We regard this as a matter of some concern. Furthermore, there is a risk that long-term higher inflation – generated by adjusting implicit or explicit inflation goals – may form part of the means to tackle the stacked up government debts.

The support measures have been served up as the main course. Inflation is on the menu for dessert, and in our view has already been ordered. It will take pro-active, tenacious policymakers to ensure that it is does not actually reach the table.
Stellar performance credit markets
European credit markets recorded a stellar performance in 2009. Total corporate issuance reached unprecedented levels at €240 billion. Double-digit (low teens for investment-grade and 60% for high-yield) returns have attracted record levels of inflow and spreads have edged back to their pre-Lehman levels with hardly any new issue premiums to speak of. Towards the latter part of the year non-financial issuance has tended to be unrated, borderline investment-grade/fallen angels and pure high-yield. Whilst there are underlying positive fundamentals, 2010 is unlikely to see a repeat of the current year’s performance.

A complex field of force
Looking ahead there are many themes which will influence asset allocation and spread-directional trends: (1) economy, corporate earnings and investment willingness; (2) rates and inflation; and (3) mergers and acquisitions. In investment-grade, creditworthiness is expected to remain stable as corporates continue to rein in spending and hoard liquidity. The first leg of the rally in risk assets is being driven by stimulus packages and corporate cost-cutting. Event risk has emerged again more recently (e.g. Adecco/MPS, Kraft/Cadbury) in a variety of corporate sectors.

An appealing alternative to bank credit
On the funding side, the banks’ focus on solvency and a higher cost of capital will continue to constrain any meaningful expansion of the loan books. Capital markets will carry on providing good funding opportunities in the investment-grade sector. This also applies to some extent to the better tier of high-yield issuers, fallen angels and good household names. Amongst the lower tier of high-yield, optimism would quickly fade away were the recovery to be drawn out. The default rate has remained within the expected range (likely to peak by the end of 2009), and this is in part the result of a record low interest rate environment, and the previously easy credit conditions of the boom years of 2006-07. Companies have also been able to request waivers to their covenants or restructure, which has helped defuse the potential leverage refinancing bomb, but the 2009 restructurings have also seen minimal deleveraging.

New reality
Many of the large creditworthy corporates have come to the market for refinancing during 2009, and less funding is likely to be required next year. The technical bid for credit remains supportive of spreads in the short-term. The direction spreads will take will ultimately depend on the shape of the economic recovery. As the default rate is expected to continue to decline, credit will likely lose out to equity in a V-shaped recovery, whilst in a slow-growth recovery, where rates would be kept low for longer, tightening could continue at a slow pace. However the quasi-disappearance of the leveraged bid (hedge funds, CDOs, SIVs), the higher cost of capital and allowances for tail risk are likely to constrain the spread tightening in a new world that includes heightened government regulation, lower consumption and slower growth.
Hope of recovery
**FX: a cyclical US dollar bounce amid a structural downtrend**

The greenback has been in a structural downtrend for the past 25 years. The broad DXY index, which tracks the US dollar versus a basket of 6 major currencies, more than halved after the peak in 1985. Periods of extreme short-term negativity have nevertheless been interspersed by cyclical rebounds. Recent examples of that include the bearish periods from the start of 2002 to the end of 2004 and late 2005 to mid 2008 (figure 27), both of which were followed by short-term cyclical recoveries, after which broader structural negatives reasserted themselves. But as the financial crisis unfolded we have been treated to a rollercoaster ride in the past 12-18 months as financial dynamics downplayed longer term structural influences.

**Torn between the safe haven and the long-haul**

In recent history the dollar initially rallied strongly on the basis of a flight to liquidity in the aftermath of the collapse of Lehman Brothers, as investors returned to either default positions or the liquidity and safety at the short end of the yield curve amid fears over the collapse of the financial system. We have subsequently seen the US dollar underperform in an environment of increased risk appetite. Investors began to treat the USD as a funding currency, i.e. investors borrowed "cheap" US dollars to invest in higher yielding currencies. Ignoring medium-term FX fundamentals such as relative growth and interest rate spreads over short-term factors such as risk appetite can only go so far, however. The question therefore is when the market will return to the former and put less emphasis on the latter.

**Cyclical dollar recovery 2010**

The USD weakness during much of H2 2009, as evidenced by the retreat in the DXY index back towards 2005-2008 cyclical lows, opens the prospect of another short-term cyclical USD bounce in 2010. While such a rebound would be a temporary affair amid long-term structural negatives linked to substantial fiscal and current account deficits, it nevertheless promises to become a meaningful event when looking at stretched market positioning. The answer to the question when the market will return to medium-term FX fundamentals such as relative growth and interest rate differentials lies in no small part with the Fed. Against the backdrop of massive monetary stimulus and record low rates, even a timid recovery should be sufficient to persuade the Fed to hike rates. While we expect the first steps towards interest rate normalization won't begin until August 2010, the mere prospect of FOMC tightening should send shock waves through the market.

When we take a specific look at EUR/USD, a couple of factors stand out. Our forecasts point at a faster flattening in the US curve amid widening long end spreads which will favour the USD, while growth differentials clearly favour the US economy over the eurozone. It is also clear that EUR/USD is also residing at rather painful levels for the eurozone economies, in particular for those economies already
Box 3: Saying Good-bye to the dollar era?

“The dollar is our currency but your problem.” These were the words of one-time US Treasury Secretary John Connally, and they describe the role of the US dollar in the world to this day. The dollar remains the world’s most important currency, much to the displeasure of those who would like to see alternatives, particularly with US politicians scarcely concerned with the weakness of its currency. Despite all the rhetoric in the media, this situation will not change any time soon, although the dollar is certainly steadily losing ground.

The ongoing discussion about significant diversification away from the dollar appears limited to hard talking. If we look at the currency composition of global reserves, we see that 62.7% of these are still denominated in US dollars. To put this figure in context, it must be acknowledged that this share has been on a downward trend in the past ten years from a high of 78%. On the other hand, the currency composition of part of the global currency reserves is unknown. This unknown quantity includes China’s reserves. Rough estimates put Chinese reserves as high as 75% in dollars. If this is the case, the dollar share of total world dollar reserves – with and without publicly known currency composition – is probably higher than the 62.7% reported in the statistics. The Triennial Survey of the Bank for International Settlements (BIS) is also useful for showing how much pull the dollar has lost. Apparently it has not lost that much, because according to the BIS, it is still the world’s most important currency, enjoying a large and stable share in daily currency trading and in the derivatives market.

A strategic withdrawal from the dollar may well be underway, but one that is proceeding at a glacial pace. It will not be years, but decades, before a withdrawal from the dollar is complete. Why is this? First, because of the sizeable adjustment problem in the surplus countries of the Middle and Far East. Although these countries are uncomfortable with the long-term outlook for the dollar, they have bought so heavily into this currency that they cannot easily divest themselves of it. China is a singular case, with currency reserves in the order of some $2.3 billion. On account of this mountain of accumulated dollar reserves from the past, a shift from the dollar would be too expensive because of the devaluation that would occur to the existing reserves. A second reason for the slow withdrawal is because the surplus countries mainly stockpile reserves in order to keep their currency artificially low against the dollar. This is to support their own export-led growth strategy. A significant diversification away from the dollar could jeopardize exchange rate policy and ultimately export growth and the growth model. Third, US financial markets still offer liquid investment instruments that are attractive to investors throughout the world, not least to emerging economies that have yet to beef up their own financial markets in order to retain their newly earned wealth.

Taking a long term view, the importance of the dollar is likely to wane. But it would be a mistake to suppose that the dollar’s position will be taken over by a single rival currency. We envisage a multi-polar currency landscape, with an increasing role for the euro, but also for the emerging currencies of China and India, during the further development of their political, economic and financial systems. For the coming years, this bodes for a certain caution with one’s investments, and reducing one’s dollar portfolio would be ill-advised on the basis of presumed diversification away from the dollar. After all, the main players in the game have not yet put their money where their mouth is.”
under pressure and who have greater trade exposures outside the euro area. Looking at PPP fair value measures for EUR/USD, we reach an estimate of US$1.22. It’s hardly a perfect measure, but it does tell us something of the scope for a cyclical rebound in the USD.

The line of least resistance
We’d also underscore from a structural point of view, looking at global imbalances, the US trade deficit in the year to September of US$243bn against an annual peak of US$760bn in 2006, most of which is against Asia, underlining that most of the USD’s adjustment should be against the broad spectrum of Asian currencies. We expect to see some adjustment in 2010 in USD/Asia along these lines, but Asian governments remain hesitant for the time being (figure 28). That in turn still leaves the euro exposed as the path of least resistance beyond 2010, even as the eurozone economies could do without the burden of a strong currency.

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1 Based on the Case-Shiller Composite-20 index.
2 Based on the S&P 500 index.
3 See also the contribution Globalization at a crossroads: World Trade in the Special Report that was published in conjunction with this Outlook on 2010.
5 This index consists of euro (57.6%), yen (13.6%), sterling (11.9%), Canadian dollar (9.1%), Swedish crown (4.2%) and Swiss franc (3.6%).
6 See also the contribution Globalization at a crossroads: Economic Imbalances in the Special Report that was published in conjunction with this Outlook on 2010.
Since the third quarter of 2009 the Netherlands is officially out of recession. A recession that has caused the real economy to shrink by 5.5% in total. The statistics tell us that economic activity has found the way upwards, but for many people this will sound hollow as they experience declining purchasing power and increased taxation. The expected real economic growth of a meagre 1% in the Netherlands in 2010 illustrates the painful and uncertain recovery that lies ahead.

A shaky recovery
During the last quarter of 2008 and the first quarter of 2009, the Dutch economy fell into a deep hole. In the first quarter of this year, the economy contracted by 5.4% compared to a year earlier. In the second quarter, the economy continued to shrink, but the decline of 1.1% quarter-on-quarter was less marked than the previous quarter (Figure 29). This improvement continued in the third quarter, showing quarter-on-quarter economic growth for the first time since early 2008. It would appear therefore, that the economy, at least in growth terms has gradually begun to emerge from the hole. But the fall it took was very severe, and the climb back up will be an unsteady one. The challenges ahead remain undiminished.
The focus on growth percentages masks the actual consequences of the economic recession for the prosperity of the Dutch. As soon as growth is positive, the recession is officially over, we are told. But it can take years before the loss of output has been restored. In 2009 the Dutch economy is expected to contract by an average of 4%. This means that our standard of living, expressed in terms of the size of the Dutch economy, will be comparable at the end of 2009 to that of late 2006 (Figure 30). In our estimation, it will take until 2014 for us to get back to the wealth levels of mid-2008 before the economy hurtled down the hill.

What goes down, must come up?

In terms of growth, the economic outlook may seem more positive than in terms of levels; but the percentual change of those levels gives cause for concern too. In the short term, growth will chiefly be determined by cyclical factors. Actual growth is now lower as a result of the economic consequences of the financial crisis, such as loss of confidence, wealth losses and a decline in credit growth.

In the long term, growth depends on the so-called growth potential. Potential growth is determined by the long-term growth of labour productivity and the change in equilibrium unemployment. Important aspects in this respect include the development of labour participation and the innovative capacity of the economy. Population ageing, for instance, will, unless addressed, contribute to slower growth of the labour supply, pushing the growth potential downwards. In 2006 the Netherlands Bureau for Economic Policy Analysis (CPB) estimated the growth potential of the Dutch economy for the period 2008-2011 at 2%. In the short term, growth may turn out to be lower than potential growth, but the opposite is also possible. The difference between actual and potential production levels is known as the output gap. Partly due to the current crisis, we now have a negative output gap. We are producing at a level that is well below potential.
The question is whether the recession has consequences for the growth potential of the Dutch economy? Or is the loss of production compared to the old growth path merely temporary? In the latter scenario, the economy will duly return to pre-crisis levels of production. This means a relatively rapid and steep recovery of economic growth. However, this optimistic scenario is unlikely for a number of reasons. In our estimation, the economy will recover more slowly, at a pace of 1% in 2010. On the basis of our expectations, actual growth during the period 2008-2011 will average at 0%. The loss of production, in relation to production potential will amount to about 8% for this period.

According to most analyses of previous serious financial crises, the loss of production during and after a recession is generally not made up by higher growth in the years immediately following. The economy does not revert within a short period to pre-crisis levels. The IMF has studied almost ninety bank crises that occurred during the last century and has concluded that average production levels seven years after a banking crisis were almost 10% lower than the pre-crisis trend.2 An important aspect in this respect is the local nature of the crises that were analysed. The experiences in Japan and Sweden, which suffered financial crises in the nineties show that the implications for production loss and growth path can vary greatly from one country to another and largely depend on the policy response. In contrast to Japan, the Swedish authorities' prompt tackling of the problems in the banking sector and their radical restructuring of the Swedish economy ensured that production losses caused by the crisis were made up by stronger growth in the years following. However, in view of the global character of the current crisis and the severe economic contraction of recent quarters, the IMF’s above conclusions would appear to be applicable today. The longer and the deeper a recession, the less is invested in capital goods and in R&D and innovation. Furthermore, companies can only adapt staffing levels to production with a lag. This slows productivity growth, and places a drag on economic growth potential in the medium term. Moreover, the financial crisis has put a large dent in the government budget. The Dutch budgetary deficit is expected to rise to 6¼% of GDP next year. The government’s efforts to restore order to its finances via cutbacks and tax hikes will likely put downward pressure on economic growth during the coming years. Our earlier calculations show that economic growth in the Netherlands will be slowed by on average 0.2% to 0.3%-points per annum for an eight year period.3 We expect that real growth in the medium term in the Netherlands will average at 1½ to 1¾%. There is considerable uncertainty surrounding the exact growth potential, because government plans for the coming years are not fully known. However, it may be said with some confidence that the potential growth in the years ahead is lower than the 2% stated. Thus the economy will embark on a long-term lower growth path, and production losses in relation to the potential pre-crisis level will increase further in the future (Figure 31). By 2015 production losses will rise to some 9 to 10% of real GDP, which is more than the 8% that the country has already endured, and is approximately equal to the damage historically inflicted on an economy by a financial crisis.
Recovery in world trade gives grounds for hope

Signs of recovery in world trade give the greatest grounds for hope to the Dutch economy. The volume of Dutch exports has already benefited in recent months from the improved conditions, such as increased production among important trade partners compared to previous months. In the period from May to July, month-on-month volume development of exports was positive. However, in August, export volume recorded a drop of over 5% compared to a month earlier. And compared to a year ago, the decline in export volume in August was almost 9% compared to a decline of 6% in the previous month. Despite this slight deterioration, the trend in export volume is still an improvement on the first six months of 2009, when real exports fell by an average of almost 13% year on year (Figure 32). All the same, a further improvement in exports during the final months of this year will not be able to prevent the volume of exports for 2009 from being some 8½% lower than in 2008. In 2010 growth is expected to reach a modest 4½%, making a return to the prodigious year-on-year growth averaging at 8% of the boom years of 2004-2007 highly unlikely. After 2010 we expect exports to grow by an average of 4½% annually, in line with projected world trade growth – lower than what we were accustomed to in recent years.4

Imports are undergoing a similar development, although the year-on-year decline since May has been greater than that for exports. On balance, therefore, net exports have made a positive contribution to growth in the second and the third quarter (Figure 29). In 2010 GDP growth is expected to be virtually entirely driven by international trade. The subdued development of domestic demand is putting downward pressure on the development of real imports. For 2010 on balance we expect to see modest growth of import volumes by an average of 3%, lagging behind the growth of exports. Likewise, in the period 2011-2015, the growth of real imports will be below the long-term average, amounting to some 4% year-on-year. This compares to a rate of 5% in the past decades.

Source: Rabobank

Figure 31: Potential output

Source: Rabobank

Figure 32: International trade only ray of hope

Source: CPB, CBS
The moderately positive picture for international trade is couched in major global uncertainties. Government stimulus packages worldwide have boosted demand for cars, for instance. However, the temporary nature of these measures means that their effect will have worn off or even disappeared completely in 2010. Governments are battling with enormous budgetary deficits. Consequently there is little room for further stimulus policy in 2010 to the same extent, let alone increasing the measures. Accordingly, demand will be lower than a year earlier. Likewise, inventory re-building, which accounted for some extra production in recent months, will only make a temporary contribution to global demand.

**Mood improving among producers**

At the same time, producers have become considerably less negative about their order books in recent months (*Figure 33*), and sentiment has improved. Whereas the indicator was down at almost -22 in February, by October producer confidence had risen to -7.8.

This improvement in mood would appear justified, because production volumes rose in July and August month-on-month. Nonetheless, volumes remain much lower on a year-on-year basis – down by some 8% in August. This puts real production still at an exceptionally low level. The same applies to capacity utilization. In October, only 77.5% of available production capacity was in use.

Against this background it is unsurprising that the volume of private investment is expected to decline by 15% in 2009. And for next year, we expect a further average drop in corporate investment of 3¾%. At the same time, companies’ profitability will improve next year, albeit at the expense of jobs, which can be expected to lead to some recovery in investment activity in the course of the year. In any case, investment is necessary in the long term. During the period 2011-2015 we expect the volume of investment to grow by 3¾% on average annually. Thus the growth of real investment will be just above the long-term average of over 3%, partly as a result of the catch-up effect of the initial period.

*Figure 33: Production no longer on the downgrade*

3-month average

Source: CBS
Consumers are uncertain
Like producers, consumers are somewhat more confident about the future. Consumer confidence improved from -34 in March to -19 in October. Still, as is the case with producers, the pessimists hold sway. The improvement in consumer sentiment, such as it is, offers cold comfort for the development of consumption, which faces rising unemployment and diminishing purchasing power in the months ahead. In August, the volume of consumption dropped by over 4% month-on-month, while the development of real consumer spending had been positive in the months of May to July. It appears that consumers are putting off the purchase of durable goods in particular. Accordingly, the decline in real consumption can mainly be attributed to savings in this category. On the whole, the volume of consumption is expected to drop by an average of 2¾% in 2009. Next year, the consumer will spend even less, and real consumption will likely drop by a further 1%. Nor are the long-term prospects much better: we envisage an average growth of ¼% in the volume of consumer spending for the period 2011-2015. After averaging 3% for years, consumers are clearly playing cautious.

While consumers are clearly reluctant to spend money, they show no inhibition about doing the opposite: saving. In 2009 and 2010, consumers will save some 14% of their disposable income. Thus they will try to compensate for wealth losses. Uncertainty about the future is also influencing saving patterns. The recession pushed up unemployment from 3.7% in September 2008 to 5.1% a year later. In the coming months unemployment is expected to rise further to an average of 5% and 7¼% in 2009 and 2010 respectively. And with an expected average jobless figure of 6½% in the period 2011-2015 the situation on the labour market is not set to improve for a while. At the same time, the spectre of the 1980s need not be feared. Fundamental changes in the labour market mean that conditions are better than was the case then (see the chapter ‘The spectre of the eighties’ later in this publication).
Inflation the only upside

The good news in 2009 comes from inflation. At an expected average of 1% for the year, inflation is low. With prices rising only slightly compared to income development, purchasing power is strong. However, this is not without risks, particularly in combination with overcapacity in the economy and the expected slow pace of economic recovery. Inflation could easily turn into deflation – a decline in average prices. Deflation initially means an increase in purchasing power, but this in turn can mean that purchases are postponed in the hope that prices will drop further. This can push the economy into a downward spiral. However, it is our view that fear for deflation in the Netherlands is unjustified.

Inflation fell sharply in July – from 1.4% compared to a year earlier in June to 0.2% (Figure 35). This was chiefly due to the half-yearly energy price adjustment in July. However, since reaching a trough in December 2008, the price of crude oil has been steadily climbing, strengthened by the recovery in the global economy. This has been reflected by a slight rise in inflation between July and October from 0.2% to 0.7%. We expect inflation to be pushed up further in the coming months by rising fuel prices. The strong position of the euro vis à vis the dollar on the other hand, is pushing import prices down. Core inflation (which excludes price changes in food and energy) was still at 1.3% in October. This represents a drop of 0.1% on the previous month, but a rise of 0.2% compared to July. On balance we expect a moderate rise of some 1% in the average price for 2009 and 2010. In the longer term, inflation will remain very moderate at 1¼% for the 2011-2015 period.

Housing market stabilising

In line with the general economic picture, the Dutch housing market appears to be recovering somewhat. Although the number of transactions is still about one third lower than a year ago, prices seem to have more or less reached their bottom. Accordingly, house prices are reacting strongly (although with a lag) to the development of economic growth in the past year: the most acute decline in house prices – measured on various indices - occurred hot on the heels of the quarters with the strongest decline in economic activity.
House prices are still declining on a year-on-year basis (Figure 36). The median house price as calculated by the Netherlands Association of Real Estate Brokers (NVM) has fallen by 6.9% during the past four quarters. This drop took place entirely during the fourth quarter of 2008 and the first quarter of 2009. After this the curve moved cautiously upward. Furthermore, the rising trend in the past half year applies to all house types with only one exception. Apartments, which dropped least sharply in the first place, were €1,000 cheaper in the third quarter compared to the second quarter. Some things can be said though against the NVM figures, particularly in the light of compositional effects. For example, fewer houses in the expensive bracket are currently changing hands, which automatically pushes the median (the middle observation) house price down. Thus the current median house being sold is of poorer quality and/or smaller than a year ago. Nonetheless, the NVM data are relevant, particularly as they precede other Dutch house price series by about three months. The other series take better account of the fact that during an economic slowdown it is more expensive houses that sell slowest. These indices, such as the PBK series of CBS/Land Registry and the WOX series of ABF Valuation are expected to show a drop in average house prices for 2009 of some 3%, assuming the market to be stabilising.

In 2010 house prices will again move in tandem with economic development. On the one hand, there will probably be a slight improvement in confidence thanks to better economic news. On the other hand, however, unemployment is rising. A stabilisation of the current price level, accompanied by an ongoing relatively low number of transactions is the most likely scenario..

**Government finances: procrastination not the solution**

We remain concerned about Dutch government finances. In 2010, the government budget deficit is expected to total 6¾% of GDP. This hole will have to be plugged in the years ahead by cutbacks or higher taxes. However, the government has put off making these painful decisions by first awaiting the advice of administrative working groups in various policy areas. These think-tanks have been charged with finding ways to map out savings of up to 20% in some cases. The danger is that by postponing these difficult and ambitious retrenchment decisions they will be put off altogether, or at least toned down, particularly with the general elections of 2011 around the corner.
To conclude
The Dutch economy is caught between hope and fear. Hope, because the recession in the Netherlands is over. Hope, thanks to the encouraging recovery in world trade. Fear, that the recovery will not be sustained on account of a lack of final demand. Fear, that restoring order to government finances will be a drag on growth in the coming years. And fear of the spectre of the eighties regarding unemployment and with it deflation, although this is largely unfounded. The labour market is in a better position than it was thirty years ago. And the deflation genie in the Netherlands will soon be firmly back in its bottle.

However, it seems inevitable that this crisis has inflicted long-term damage on the growth potential of the Dutch economy and that it will take more than five years to recoup the wealth lost during the past year. While 2010 will show some positive growth figures, it should mainly be seen as a year of stabilisation. And stabilisation is always better than the dramatic numbers of the past year. We also expect the housing market to enter calmer waters amid these cyclical waves.

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1 Het groeipotentieel van de Nederlandse economie tot 2011, CPB Document 117, June 2006
2 What’s the damage? Medium-term output dynamics after financial crises, IMF, World Economic Outlook, Chapter 4, October 2009
3 See the focus article on budgetary policy in the Economic Quarterly of September 2009
4 See the chapter ‘Globalization at a crossroads: World Trade’ in the special report that has been published in conjunction with this Outlook
5 See also the Rabobank Special Report 2009/17 on the 2010 national budget.
Hope of recovery
The spectre of the eighties

Unemployment is rising steeply in the current recession, evoking memories of the start of the eighties, the last time the Netherlands experienced mass unemployment. But in our view the labour market is better placed than at the start of the eighties. This is partly due to the greater flexibility of today’s labour market, but to a far greater extent to demographic developments.
Seventies: crisis leads to unemployment

At the start of the seventies, the Dutch labour market, with negligible unemployment, was very tight by today’s standards. OPEC cut off the oil supply twice, in the mid-seventies and towards their end. These were massive shocks for the economy, contributing to a sharp decline in the volume of world trade at the end of the seventies and the start of the eighties. A lasting recession ensued during which the number of jobs fell for several years in succession. Conversely, this coincided with growth of the labour force. The baby boom that had occurred in the ten years after the war resulted in a major influx in the labour market in the seventies. In addition to the temporarily higher influx, an increase in the participation rate also bolstered underlying labour supply. High wages, which rose along with the sharply accelerating inflation, resulted in high wage costs for businesses and depressed their profitability. Given the simultaneous decrease in jobs and the increase in labour supply, unemployment exploded (see figure 37). In 1984, unemployment was well over 10%. The job losses and the increase in labour supply were accompanied by an expansion and growth of the system of social security. The government was initially able to apply its high natural gas revenues to finance the strong growth in social security without a skyrocketing budget deficit. Over time, however, the generous social security system led to higher social security contributions, lower employment due to the erosion of the profitability of businesses, lower economic growth and lasting high unemployment. In addition, the natural gas exports led to a surplus of the current account of the balance of payments and an appreciation of the guilder, adversely impacting the price competitiveness of Dutch business. The phenomenon of mineral resources being applied to lead not to higher but lower economic growth caused the Netherlands to be internationally known for this “Dutch Disease”.

Figure 37: Unemployment in the Netherlands

Source: Rabobank
**Eighties: lasting high unemployment**

Unemployment did not just rise very rapidly to high levels in the first half of the eighties, but subsequently also fell only haltingly. This phenomenon in which high unemployment appears to be reinforcing itself is known as hysteresis. In the eighties various factors combined to produce it: high interest rates, non-incentivising social security and persistently high real wages limited flexibility in the labour market.

The high real interest rates made it expensive for businesses to invest, damping economic growth. Sectors such as shipbuilding and the textile industry, which had already been troubled for years, disappeared virtually completely in their traditional form. The slow recovery from the recession meant that people who were laid off remained unemployed for comparatively long periods, to which the non-incentivising social security system also contributed. Long-term unemployment is a major driver of hysteresis. It causes employees to lose part of their skills which in turn makes it harder for them to find a new job. They become less relevant to the labour market, as it were.

This was exacerbated by the fact that labour market policy was not particularly incentivising. The duration and amount of benefit payments tended, on the contrary, to offer disincentives. The replacement rate – the level of benefits compared to the level of the last-earned salary – was relatively high and people were therefore provided with little incentive to look for work. The duration of benefit payments did not help much either. Long-term unemployment also affects the wages of those in work. The longer unemployment lasts and the more skills have been lost, the more difficult it becomes to compete with people with jobs. People in work can continue to demand high wages because people suffering long-term unemployment no longer represent a real alternative for employers to replace them with. It is opportune for employers to pay their existing employees high salaries, as taking on people after protracted unemployment will require a great deal of training.

An unusual aspect of the early eighties was that many of the redundant employees did not end up receiving unemployment benefits but disability benefits instead, or left the labour market prematurely via early retirement schemes. In view of the clouded outlook this was deemed to be the most desirable solution by the employer representative organisations and labour unions for people whose chances of success in the labour market were at best slight anyhow. Those who had left the labour market via this route hardly ever came back. Employers were consequently even more dependent on their existing workforce. Owing to these forms of inactivity, the number of people who were not working was actually much higher than the official unemployment figures would suggest.

Traditionally wages were in the Netherlands linked to price increases (Cost of Living Adjustments, Cola’s) in the great majority of collective labour agreements. Therefore real wages did not fall even though wage costs were harmfully high. This
Stranglehold was broken in 1982 by the Wassenaar agreement. In return for abolishing the clauses on Cola’s, working weeks were shortened and wage moderation was supported by cuts in taxation and social security contributions. Shortening the working week was also a way of dividing the available work between more people. Whether it was effective remains unclear to this day. In addition, part-time work, which became increasingly popular since the eighties, meant that large groups of people, and women in particular, were entering the labour market for the first time.

Unemployment only started to edge down gradually in the second half of the eighties. The main reason why it remained high for a long period at that time was the combination of a sharply rising labour supply and a labour market that was slow in becoming more flexible. This flexibility relates to both social security and the flexible layer of labour that arose in addition. The higher economic growth in the second half of the eighties compared to the preceding years caused employment to grow, but at the same time the participation rate also rose rapidly and there was a sizeable encouraged worker effect: many who had remained sidelined when the chances of employment were low started once more to look for jobs when employment opportunities were on the rise again. The persistently high level of unemployment in the second half of the eighties therefore masks the underlying fact that the labour force actually displayed strong growth. The economy did not, however, immediately grow fast enough to provide jobs for everyone.
The current recession

The recession we are experiencing now is of an unprecedented depth, with the economy contracting 4% in volume this year. This recession is much deeper than that of the eighties. And with four successive quarters of contraction to look back on, it has also lasted long already. Production levels have fallen sharply and it will certainly take several years before we return to the levels of prosperity of 2008. Even if the recession is nearing its end, unemployment will continue to rise for some time as the labour market always lags behind cyclical economic change. We expect job losses to total some 400,000 FTEs this time, around 5% of job supply. At the start of the eighties the corresponding figure was 160,000 jobs, just shy of 4% of job supply at the time. Expected job losses are greater than at the start of the eighties chiefly because of the depth of the present recession. The economy contracted by 1.8% in 1981-1982 but by over twice as much this year. Given this fast backtracking of the economy, the labour market is in fact holding up astonishingly well. One reason is that the tightness in the labour market was fairly pronounced in the past few years. Many businesses are now eliminating vacancies, but not necessarily jobs. Entrepreneurs looking ahead may in addition be well aware of the wave of baby boomers about to leave the labour market. Businesses may be holding on to their people to avoid running into shortages of good staff again in due course. This is leading to a comparatively strong fall in productivity this year but is set to be compensated next year if production picks up again slightly and employment continues to shrink. Compared to the eighties, labour is also far less expensive, in relative terms. The labour income ratio - the portion of added value going to the factor labour – was around 87% for almost ten years at the end of the seventies and the start of the eighties (see figure 38). This is set to fall to well below 78.5% next year. The profit ratio reached a low of less than 2% in 1980. Although the profit ratio is also declining at present, it is still fluctuating at around 10%. Businesses have fattened up considerably in the past few years and therefore now have the financial resources not to have to cut jobs too rapidly.

Figure 38: Labour income ratio

Source: CBS
**The eighties and now: major differences**

Besides the relatively limited contraction in employment there are several other reasons why we do not expect an eighties scenario for unemployment. Much has changed in the labour market since then. We set out a number of comparisons in various areas below.

**Labour supply**

As we wrote above, demographic labour supply increased considerably at the start of the eighties. In conjunction with a higher participation rate this led to high unemployment. Between 1979 and 1989 the labour force increased by almost 20%. We expect the opposite to occur in the next few years: the labour force potential to grow has come to an end for the time being. Depending on movements in labour participation the working population might even decline. The baby boom generation will retire and therefore be eliminated from the labour supply. Although this effect will be mitigated to some extent as the trend to postpone retirement is set to continue for a while (partly owing to the increase in the statutory retirement age), that will not be enough. Flatter growth or an actual decline in labour supply tempers unemployment. We therefore do not need, as we did in the eighties, a sharp increase in job supply to find jobs for people newly entering the labour market.

**Flexible layer of labour**

Owing to the rise of temporary agency workers (since the seventies) short-term contracts and one-person businesses, businesses no longer need to employ their entire workforce permanently. Temporary agency work has grown enormously since the end of the eighties. Since the mid-nineties, some 10% of employees are working on the basis of flexible contracts. One-year contracts were made possible by law in the nineties. The flexible employment act (flexwet - 1996) did cap the number of permissible extensions of one-year contracts at two. After three years, an open-ended contract or dismissal is mandated. The self-employed person without personnel is a more recent phenomenon (Zelfstandige Zonder Personeel - ZZP). Small independent businesses are of course nothing new. But they have become a trend in the past few years. A self-employed person without personnel often continues to do the same work as when permanently employed, but on a subcontractor basis. Some self-employed people have taken this step to increase their earnings. Others were more or less forced into it because employers no longer wished to take the risk of having too many people on their payroll. In 2008, Statistics Netherlands had registered 641,000 self-employed persons without personnel. Compared to 1996 that is an increase of 60% (*see figure 39*).

Self-employed persons dampen unemployment and delay the rise of unemployment. Damping occurs if a self-employed person runs into difficulties but survives the recession. In that case the self-employed person has to contend with lower turnover and lower income but does not become unemployed. A portion of the self-employed persons will not survive the economic downturn. Eventually they will answer the question put to them by Statistics Netherlands (CBS) whether they...
are looking for a job of 12 hours or more a week and are available immediately – which is the yardstick for unemployment in the Netherlands – in the affirmative. But initially they will aim to halt the decrease in turnover by devoting extra time to finding new projects and customers. They will not have any time at all for a job of 12 hours or more a week. Only when work dries up to an extent that they can no longer remain afloat are they registered as unemployed.

In addition to the flexible layer of Dutch employees a new group of flexible employees has been added, particularly since the opening of the borders for Eastern European employees. Poles in particular (over 85%), but also Bulgarians and Romanians have come to work in the Netherlands in the past few years. Since 2006, according to the official Statistics Netherlands figures, over 100,000 Eastern Europeans have come to work in the Netherlands. According to other sources, such as the tax authorities, the number of Poles working in the Netherlands alone already exceeds 150,000. In any case the size of this flexible layer has grown substantially (see figure 40).

Due to these developments a business can source a substantial portion of its workforce in a flexible manner. That flexible portion can be easily and inexpensively shed if business temporarily falters. This dampens unemployment figures. Many Eastern Europeans return to their home and their family as soon as they have no work. They would therefore not figure in Dutch unemployment statistics, which easily makes for a difference of several tenths in percentage points.

A more recent measure that flattens unemployment statistics is the part-time unemployment scheme. This scheme, introduced as a crisis measure this spring, provides for benefits for the portion of time during which an employer has no work for an employee. The employee, however, remains in employment and is, despite temporarily having less work, not unemployed.¹

¹ Source: CBS

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Figure 39: Development of flexible layer of labour
Index, 1996 = 100

Figure 40: Eastern European employees in the Netherlands
x1000 persons (l-axis), % (r-axis)

Source: CBS
More flexible permanent workforce

In addition to a larger flexible layer of labour, much has also changed for employees with open-ended contracts. The average period during which an employee remains with the same business has declined significantly in the past thirty years. In addition, employees move to a different position within a business more frequently. This is an important factor in terms of the probability of a new period of hysteresis. Regular job and/or position changes make employees more widely employable and decrease the likelihood of long-term unemployment for them.

In addition, a larger portion of remuneration has been made flexible. Not only has the portion of variable remuneration increased (for instance in the form of performance- and profit-related pay), wage increases are less frequently granted by default. In the past, employees often received extra wage increases every year as a matter of course. At many businesses today this is part of instruments such as performance management cycles, which also afford employers greater flexibility. A final form of flexibility is the continual training and retraining of employees. By doing this, employees stay up to date with knowledge that is valuable in the labour market as well. By continually focusing on training, employees are often more employable and do not become stale in one job. This is a major advance compared to the eighties. ¹

Institutions more flexible

Much has changed, gradually, in the past thirty years in the field of social security. Benefit percentages have been reduced (for both wage-related benefits and minimum benefit payments), as a result of which the average replacement rate has declined significantly, from over 85% in 1980 to 65% in 2010. In other words, instead of benefit payments amounting to 85% of the last-earned salary people receive benefit payments that are on average only equivalent to 65% of their last-earned wage.

In addition it is much more difficult to become accepted for disability insurance schemes, as a result of which the number of persons disabled for work has declined for the first time in almost 30 years (see figure 41). The prevention process has been tightened up since the start of the nineties, as have check-ups. Also, re-examinations are more frequent. Jointly, these factors have resulted in a markedly lower influx in the successor to the unemployment benefit scheme (WAO), the work and income scheme (WIA). The duration of benefit payments for unemployment has been shortened from a maximum of five years to a maximum of 38 months (three years and two months). As a result, long-term unemployed people end up more rapidly in the income support scheme (bijstand).

Rules for receiving income support have also been tightened up considerably. Whereas in the eighties (and until far into the present century) many recipients of income support were not subject to an obligation to apply for jobs, income support policy has since then become much more incentivising. Mandatory training or acceptance of work is the standard policy applied in many municipalities. In addition, income support payments can often only be received if people have no personal capital.
The numerous changes in the labour market have certainly changed the reputation of the Netherlands in an international perspective. After having been "the sick man" of Europe, with high unemployment and many people registered as disabled for work, we have for many years been a country with very low unemployment, on an international scale.

But, as we have seen, part of that lower unemployment is attributable to lower labour supply. This easily accounts for 2 to 4% in the unemployment total. If labour supply and the participation rate were to grow as rapidly now as in the eighties, unemployment would reach not 7.25% but 9 to 11% in 2010. The applicable margins for error are obviously considerable for this, due to the disincentives for entering into the labour market.

Whether the operation of the labour market has improved can be gauged using the UV curve (or Beveridge curve). This curve shows the link between vacancy levels (V) and unemployment (U). If unemployment is low, there will be many vacancies, while if unemployment is high there will conversely be few. As the labour market operates more effectively, this slanted curve will tend to move towards the intersection of the two axes. If the curve as a whole moves up, there are more vacancies at a specific unemployment rate. This means that demand and supply are less evenly matched in the labour market or dovetail less well with each other. In other words the match is deteriorating.

On the basis of this curve it is not possible to establish firmly that the match between demand and supply in the labour market is more effective. Compared to the end of the eighties there is hardly a clear shift towards the origin, and currently in 2009 we are almost at the same point as in 1998, despite the numerous changes in the labour market in the past ten years. On balance these effects therefore appear to be limited.
A different way of looking at the operation of the labour market is in terms of underlying unemployment. Economists also call this the Non-Accelerating Inflation Rate of Unemployment (NAIRU), or the level of unemployment at which (wage) inflation will not increase. Low NAIRU levels mean that demand and supply are well-matched. Estimates of NAIRU show that these have fallen from 6% in the eighties to around 5% at the present time in the Netherlands. This in turn supports the UV curve: though much has changed in the labour market, the match between demand and supply has only improved to a limited extent.

**Conclusion**

The labour market has changed considerably in the past thirty years. However, the long-term effects on unemployment, at around 1 percentage point, are not very significant. The principal difference compared to the eighties is the change in the labour supply. Whereas that figure was still rising substantially at the start of the eighties, in the coming years progressively fewer people will be active in the labour market now that the baby boom generation is retiring.

If we add the difference in structural unemployment to the expected unemployment for 2010 and also allow for the difference in supply, we expect an unemployment rate of 10 to 12%, i.e. much higher than at the start of the eighties. We should therefore welcome the changes in the past thirty years, as we should, temporarily, the effects of ageing in the labour market.

In the slightly longer term these two key differences compared to the eighties (greater flexibility and lower supply) will also lead to a more rapid fall in unemployment. The labour market is more flexible, and therefore, unlike in the eighties, no group of people will become irrelevant to the labour market. The tightness in the labour market may return comparatively quickly, mainly as a result of demographic change. Not in 2010 or 2011, but in the period after that. Then the question will be whether the institutions in the Dutch labour market have adapted sufficiently well in the past thirty years to deal with long-term tightness as well.

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1. For a more detailed discussion of the part-time unemployment benefit scheme see the special report 2009/20 ’Part-time unemployment benefit scheme – a bridge too short?’ (‘Deeltijd-WW: Een brug te kort?’) on www.rabobank.com/kennisbank
2. CPB, MEV 2009, page 55
### Forecast Table

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<tr>
<td>2-year swap</td>
<td>0.56</td>
<td>0.60</td>
<td>0.60</td>
<td>0.80</td>
<td>0.90</td>
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<tr>
<td>10-year swap</td>
<td>1.47</td>
<td>1.40</td>
<td>1.50</td>
<td>1.60</td>
<td>1.80</td>
<td>1.90</td>
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<tr>
<td>Base rate</td>
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<tr>
<td>3-month Libor</td>
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<td>1.10</td>
<td>1.50</td>
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<td>2-year swap</td>
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<td>3.20</td>
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<tr>
<td>10-year swap</td>
<td>3.97</td>
<td>4.10</td>
<td>4.30</td>
<td>4.50</td>
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<td>5.10</td>
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#### Exchange rates

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<th>13/11/09</th>
<th>Q4-09</th>
<th>Q1-10</th>
<th>Q2-10</th>
<th>Q3-10</th>
<th>Q4-10</th>
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<tbody>
<tr>
<td>EUR / USD</td>
<td>1.49</td>
<td>1.53</td>
<td>1.50</td>
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<td>EUR / JPY</td>
<td>133.70</td>
<td>135.00</td>
<td>132.00</td>
<td>130.00</td>
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<td>EUR / GBP</td>
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<td>0.87</td>
<td>0.85</td>
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<tr>
<td>USD / CNY</td>
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<td>6.83</td>
<td>6.83</td>
<td>6.82</td>
<td>6.81</td>
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Source: Rabobank
Websites

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